CHAPTER 4

Work, Retirement, and the Economic Well-Being of the Elderly

JUST 50 YEARS AGO, the baby boom was getting under way, and about 1 out of every 12 Americans was 65 or over. Today, about one out of every eight Americans is elderly, and the oldest baby-boomers are preparing for retirement. As the baby-boomers continue to age, the elderly population will rise dramatically. It is projected that by the time the youngest baby-boomers hit age 65, in 2029, almost 20 percent of Americans will be elderly—about 2½ times the proportion in 1950.

As America adjusts to this phenomenal demographic change, it is important to assess the economic well-being and work decisions of the current and the soon-to-be elderly. A review of statistics on the well-being of older persons and the labor market outcomes of workers who are approaching retirement age yields four important conclusions. First, long-term trends in the labor force participation of older Americans, both male and female, are changing. The century-long decline in male labor force participation at older ages has leveled off since 1985. More men aged 55-64 are continuing to work, often part time or in a different occupation, after "retiring." Meanwhile the share of women aged 55-64 participating in the labor force has increased by almost 10 percentage points in the past 15 years.

Second, employer-provided pensions and health insurance are also undergoing rapid change. The share of participants in defined-contribution pension plans, such as 401(k) plans, is growing and the share in defined-benefit plans shrinking. Employer-provided health insurance coverage for retirees has also become less widespread, less generous, and more expensive. These developments have many ramifications, both for retirement incentives and for the incomes and living standards of retirees.

Third, the economic status of the elderly as a group has improved remarkably during the past three decades. Their poverty rate has fallen to less than half what it was in 1970. In that year the elderly were more than twice as likely to live in poverty as the nonelderly, but today poverty is slightly less prevalent among the elderly than it is among younger persons.

Finally, the elderly are a diverse group, which means that averages can be quite misleading. In particular, although most elderly groups—men and women, blacks and whites, older and younger elderly, single as well as married persons—have enjoyed economic progress, large disparities in well-being prevail among these groups. The most recent data show that just 4.6 percent of elderly married men, but 28.8 percent of elderly black women and 17.9 percent of elderly widows, live in poverty. And whereas Social Security benefits account for at least 80 percent of income for 38 percent of all elderly households, another 9 percent rely on Social Security for less than 20 percent of their income. Moreover, among those now approaching retirement age, over 10 percent have no financial savings whatsoever, and 30 percent have less than $1,200, whereas the top 10 percent have over $200,000 in financial assets. Over half of all blacks and Hispanics aged 51-61 have no financial holdings.

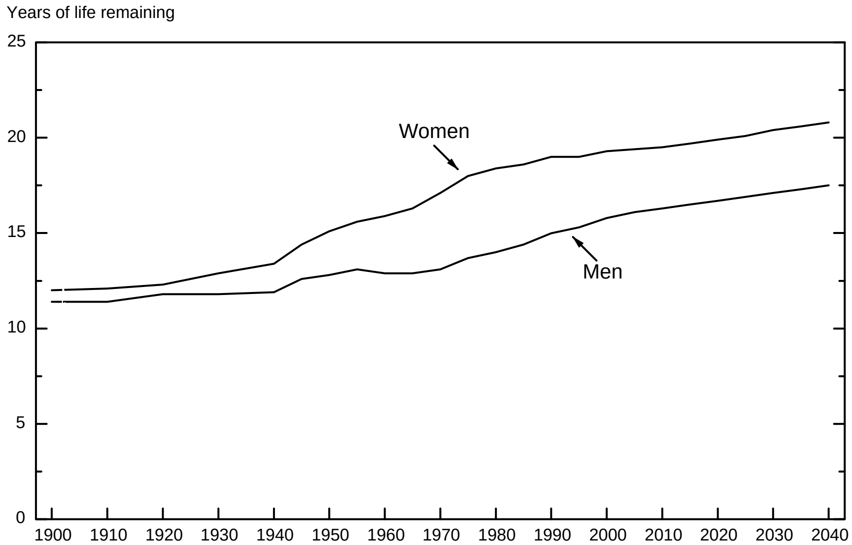
POPULATION AGING, LIFE EXPECTANCY, AND HEALTH STATUS

As we approach the 21st century, the confluence of a reduction in fertility and improvements in longevity is causing the share of older people in the population to rise. The total fertility rate—the number of children that an average woman will bear over her lifetime—has declined substantially since the turn of the century. This decline was not a steady, uninterrupted one, however: a substantial increase in fertility was associated with the baby boom of 1946-64. The total fertility rate increased from 2.3 in 1940 to 3.8 at the peak of the baby boom in 1957. It then fell to 3.2 by the end of the boom, and today the total fertility rate is about 2.0.

Life expectancy has risen throughout the 20th century. Americans today are more likely than their parents and grandparents to reach old age, and having reached that threshold they live a greater number of years thereafter. In 1900, 65-year-old men and women had similar remaining life expectancies, at 11.4 years and 12.0 years, respectively (Chart 4-1). These figures had risen by mid-century to 12.8 years for men and 15.1 years for women. The 1950s and 1960s saw substantial gains in life expectancy for older women, but stagnation for older men. Since the 1970s, however, strong gains have occurred for both sexes. Current life tables indicate that 65-year-old men and women today can expect to live an additional 15.7 years and 19.2 years, respectively. And projections imply that life expectancy will continue to increase in the next century.

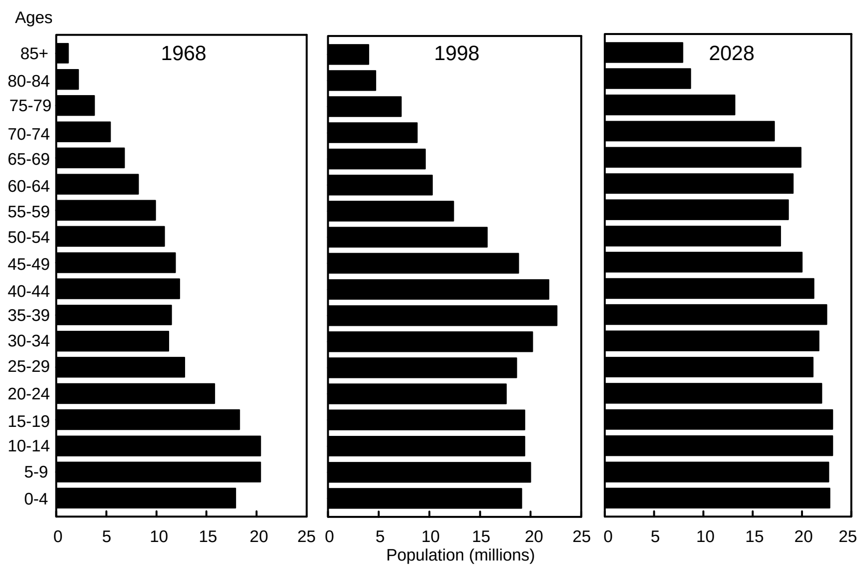
The anticipated transition of the baby-boom generation into old age has drawn attention to the aging of the population. The baby-boomers, who are currently between the ages of 35 and 53, will begin to reach age 65 by 2011. Chart 4-2 shows this bulge in the population, which swelled the number of children and adolescents 30 years ago. This group will reach retirement age over the next 30 years. Although the growth rate of the elderly population will be very low between 1995

Chart 4-1 **Life Expectancy at Age 65**
The number of years that Americans can expect to live after the age of 65 has increased throughout the 20th century and is expected to continue increasing.



Source: Data prior to 1998 from Department of Health and Human Services; 1998-2040 projections from Social Security Administration.

Chart 4-2 **Population of the United States by Age**
Baby-boomers created a bulge in the population of children and adolescents 30 years ago and will move into retirement ages over the next 30 years.



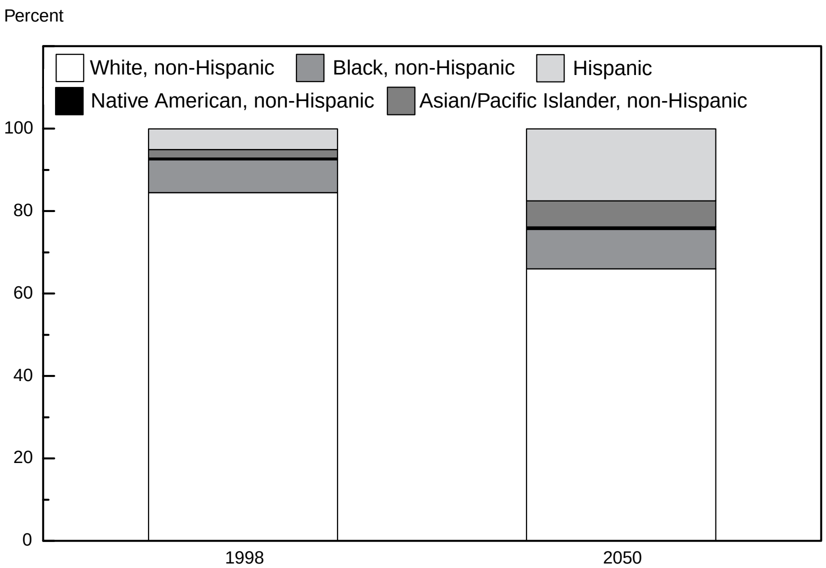
Source: Department of Commerce (Bureau of the Census).

and 2010 as a result of low fertility in the 1930s, that rate will more than double in the following 20 years. Also as a result of the baby boom, different age groups among the elderly will peak at different times: those between 65 and 74 will peak at 38 million in 2030, and those 75 to 84 will peak at 29 million 10 years later.

The “oldest old,” those aged 85 and over, are of particular concern because of their high rates of poverty and institutionalization, described below. This group will grow both in number and as a share of the population, from about 4 million today to 18 million by 2050. Accounting for about 1.5 percent of all Americans today, the oldest old are projected to make up 23 percent of the elderly population and about 5 percent of the overall population 50 years from now.

At the same time that the size of the elderly population is increasing, its racial, ethnic, and gender composition will also change. In 1998 the non-Hispanic white population accounted for the largest proportion of elderly, and their number is projected to nearly double to 52.0 million by 2050. But the proportion of non-Hispanic whites in the elderly population will decline as the numbers of elderly persons of other racial and ethnic groups grow even faster, causing their proportion of the elderly population to double (Chart 4-3). The elderly Hispanic population, for example, is expected to grow to 13.8 million in 2050, or eight times what it was in 1998. In 1994, elderly women outnumbered elderly men by a ratio of 3 to 2 overall, and by 5 to 2 among those over 85. About half of elderly women were widowed, more than three times the percentage for elderly men, who were nearly twice as likely to be married.

Chart 4-3 **Projections of the Population Aged 65 Years and Over**
The share of the elderly population that is white, non-Hispanic is projected to fall by about one-fifth between 1998 and 2050.



Source: Department of Commerce (Bureau of the Census).

Population aging is not just an American trend but a major global phenomenon—a natural result of better health and nutrition and lower fertility and mortality rates worldwide. Never before have so many people in so many societies lived for so long. Yet as much as population aging is a natural result of the benefits of increased longevity and survival among all age groups, it also represents a fundamental shift in social structure that affects labor markets, family structures, and the social contract among generations.

Increasing life expectancy does not automatically imply that health status has improved. In fact, despite improvements in mortality at older ages in the 1970s, some studies claim that the health status of the elderly worsened during that period. But since 1980 the evidence points to a decline in chronic disability among the elderly. In 1994 the number of people aged 65 and older who were disabled (that is, who had functional problems lasting 90 days or longer in dealing with various normal activities of daily living) was 14.5 percent (or 1.2 million) lower than would have been expected if the age-specific chronic disability rates observed in 1982 had persisted. This decline was found to have contributed significantly to reducing the rate of institutionalization between 1982 and 1994. However, many older Americans still require long-term care (Box 4-1).

Although disability rates have declined they are much higher in lower socioeconomic groups. In 1993, for example, persons aged 50 and over who had not graduated from high school tended to perform much worse on four measures of physical functioning than did those who had attended college.

OLDER WORKERS AND RETIREMENT

Retirement patterns have been changing over time in response to changes in institutions and in the preferences and practices of employers and workers. These changes are reflected in changing long-term trends in the labor force participation of the elderly (that is, the proportion of the older population who are either employed or looking for work), particularly the decline in labor force participation rates of older men during most of this century. Recent years, however, have seen a leveling off of this decline. Since the mid-1980s, 55- to 64-year-olds in each year have been just as likely to be in the labor force as those in the preceding years. They have been more likely to work part time and less likely to work full time, however. This section reviews these changing patterns of retirement and their causes. It turns out that a variety of factors influence the timing of retirement, such as the rules governing pensions and Social Security benefits, characteristics of jobs held by the elderly and accommodation made to impaired elderly workers, and health insurance coverage. The section concludes with a discussion of unemployment, job loss, and tenure as experienced by the elderly.

Box 4-1.—Easing the Burden of Long-Term Care

Like Social Security and Medicare, long-term care will become a primary concern of baby-boomers as they approach retirement age. In 1994 an estimated 2.1 million elderly living in the community needed help because of problems with three or more activities of daily living (such as eating, bathing, dressing, or moving around) or because of a comparable cognitive impairment. That number will rise as the population ages, and the fast-growing population of the “oldest old,” those 85 and older, is at greatest risk.

Much long-term care today is provided informally: about 65 percent of elderly persons living in the community and needing long-term care assistance rely exclusively on unpaid sources, most often family and friends. Surveys have found that 8 of every 10 caregivers provide unpaid assistance averaging 4 hours a day, 7 days a week. For many, such assistance competes with the demands of paid employment. In addition, home and community-based care requires substantial out-of-pocket expense, totaling over $5 billion in 1995.

The Administration has proposed four initiatives to help relieve the burden of families with members in need of long-term care. The first is a tax credit of up to $1,000 for people of all ages with three or more limitations in activities of daily living (or a comparable cognitive impairment). Persons needing long-term care themselves, or their family members who care for and house them, can claim the credit, which phases out at incomes of $110,000

LONG-TERM TRENDS IN LABOR FORCE PARTICIPATION AT OLDER AGES

Labor force participation rates for men 55 and older have declined during most of the 20th century. For example, the participation rate of men aged 55-64 fell from 89.5 percent in 1948 to 68.1 percent in 1998 (Chart 4-4). These trends in labor force participation are the result of two factors: trends in retirement age and trends in longevity. The average retirement age depends on the retirement rate at each age, and retirement rates have been increasing at younger ages and decreasing at older ages. Consequently, the estimated median age of retirement (defined as complete withdrawal from the labor force) for men declined, from 66.9 years in the 1950-55 period to 62.1 years in 1990-95.

Early in this century, most men worked until they died or became disabled, and both death and disability tended to occur at much younger ages than today. Today more men live longer after retiring than they did in earlier decades. Over the 1950-95 period, male life expectancy at age 65 rose by 20 percent. This helped to reduce over time the participation rate of men 65 and older, by increasing the

Box 4-1.—*continued*

for couples and $75,000 for unmarried taxpayers. The credit would provide financial support for about 2 million Americans, broadly expanding an existing set of tax allowances. Under current tax policy, taxpayers can claim the child and dependent care tax credit to cover part of the cost of care of a disabled spouse, when that cost is incurred by the taxpayer in order to work. A taxpayer who itemizes can also deduct any qualified long-term care expenses that exceed 7.5 percent of adjusted gross income. The new tax credit would defray some costs of both formal and informal care. Over half the chronically ill people thus helped will be elderly persons.

Second, the National Family Caregiver Support Program would fund State initiatives establishing “one-stop shops” that assist families caring for elderly relatives through training, counseling, and arranging for respite care.

Third, the Administration has proposed a national campaign to educate Medicare beneficiaries about the program’s limited coverage of long-term care and help inform their care decisions. The need for information is great: nearly 60 percent of Medicare beneficiaries are unaware that Medicare does not cover most long-term care.

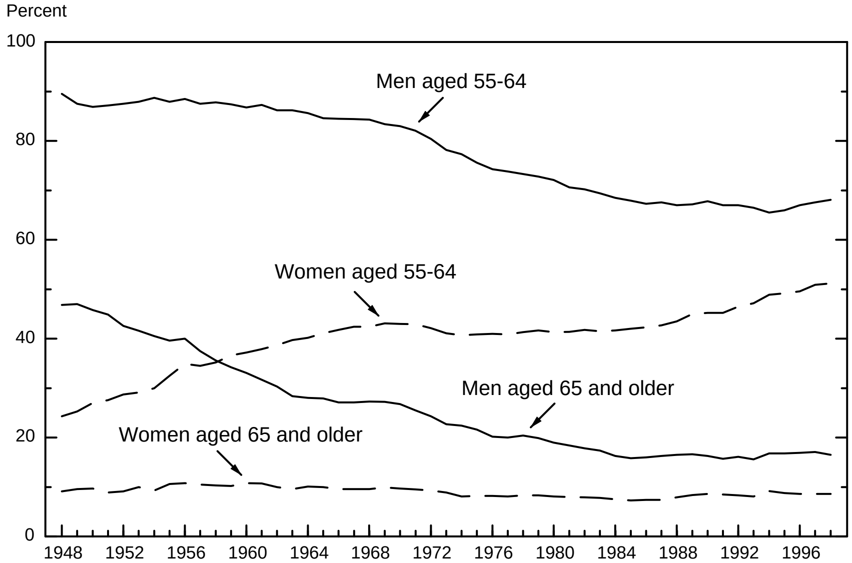
Finally, the Administration has proposed that the Federal Government serve as a model employer, by offering nonsubsidized, quality long-term care insurance to all Federal employees and using its market leverage to negotiate favorable group rates.

denominator (the total number of men in this age group). Therefore, the participation rate of men aged 65 and over has declined even more than the decline in average retirement age might suggest.

Meanwhile the labor force participation rate for women aged 55-64 has actually increased since 1948—in fact it has more than doubled, from 24.3 percent to 51.2 percent (Chart 4-4). This has happened despite a decline in women’s median retirement age, from 67.7 years in 1950-55 to 62.6 years in 1990-95, because more recent cohorts of women have been more likely to be in the labor force during most of their adult lives (Chart 4-5).

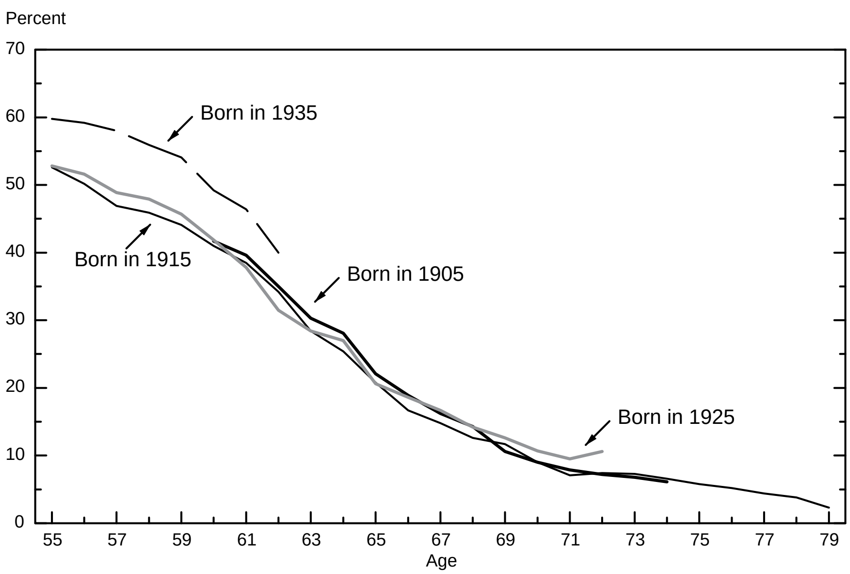
In the face of long-term improvements in health and longevity, why has the retirement age fallen, not risen, during the 20th century? Rising wages are a large part of the answer. As their earning power has risen, men have enjoyed both more income and more time for activities other than paid work. They have taken some of this additional time in the form of leisure at the end of life, as well as shorter workdays and workweeks and more holidays during the year. The growth of Social Security and employer pensions since the 1930s has also facilitated

Chart 4-4 **Labor Force Participation Rates of Older Men and Women**
Labor force participation by older men generally declined until the mid-1980s but has since leveled off; that of older women has increased since 1948.



Source: Department of Labor (Bureau of Labor Statistics).

Chart 4-5 **Women's Labor Force Participation Rates at Each Age**
Increases in the labor force participation of women across birth cohorts have offset the decline in labor force participation as women age.



Source: Department of Labor (Bureau of Labor Statistics).

earlier retirement, by increasing lifetime wealth for the early cohorts in the Social Security system and by providing income in old age. Even though earnings were rising from generation to generation, many individuals might not have saved enough to retire without these sources of income. For these reasons the average length of retirement has risen faster than the average male life expectancy at age 55; hence, the average male retirement age has fallen.

RECENT CHANGES IN THE LABOR FORCE PARTICIPATION OF OLDER MEN

There are signs that this long-term trend toward earlier retirement may have abated. Since the mid-1980s the decline in labor force participation rates for men in the older age groups has leveled off (Charts 4-4 and 4-6). Other evidence indicates that an increasing proportion of male pension recipients are continuing to work. For example, in March 1984, 37 percent of men aged 55-61 who had received pension income in the previous year were working. By March 1993 this number had climbed to 49 percent.

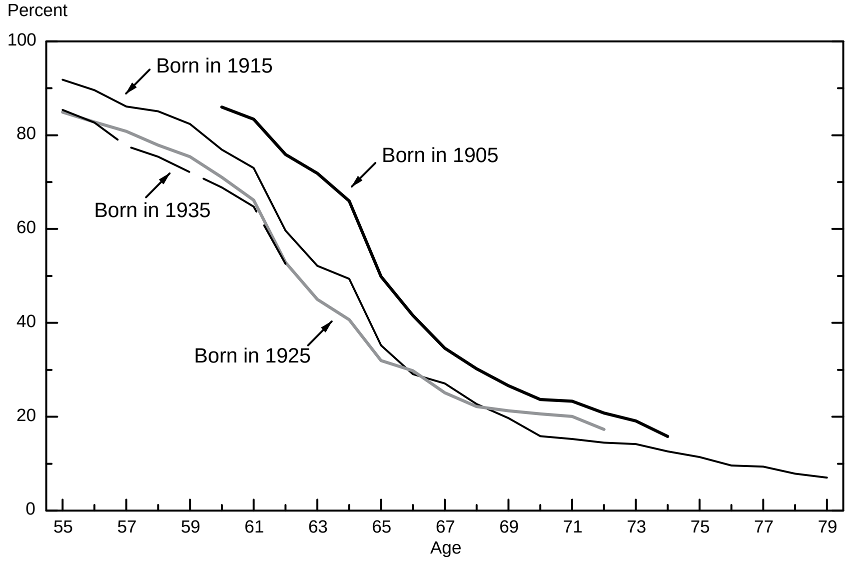
Rather than withdrawing from the labor force completely, many older men are leaving long-term career jobs but continuing to work, often part time or part year. Many are becoming self-employed. Chart 4-7 shows, for example, that between 1985 and 1997 the fraction of men aged 60-61 who worked full time, year round declined from 55.1 percent to 51.8 percent, while the fraction working part time increased from 5.7 percent to 10.4 percent. Increases in part-time work also occurred among men in other age groups. In 1997, 16 percent of employed men aged 55-64 and 30 percent of those 65 and over were self-employed.

The use of "bridge jobs" between a full-time career and complete retirement is not a new phenomenon. Evidence from the 1970s indicates that even then about a quarter of older workers took such transitional jobs. More recent evidence suggests that a somewhat higher percentage may be taking such jobs since 1985.

What accounts for the apparent stalling of the decline in male labor force participation at older ages? It is not yet clear whether the leveling off since the mid-1980s is a short-term, cyclical phenomenon or a new long-term pattern. And in any case, older men's hours of work are still falling, even if the percentage of older men working is not, because of the shift from full-time to part-time work seen in Chart 4-7.

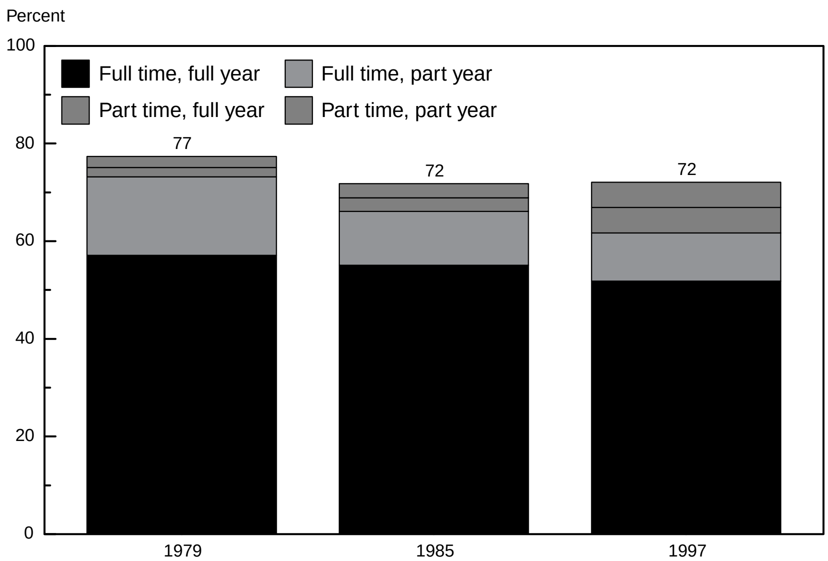
The recent increase in work by pensioners may stem from a need for income by those who were displaced during the recession of 1990-91. Some elderly persons cannot afford full-time leisure, but can finance part-time leisure by working part time. Pension recipients' need for income may also have grown in recent years because of rising health care costs. Not only have these costs risen in general, but many employers have stopped providing health insurance to their retirees or have reduced their benefits, as discussed below. The increase in early retirement

Chart 4-6 **Men's Labor Force Participation Rates at Each Age**
Not only does men's labor force participation decline with age, but until recently each new cohort of older men had lower age-specific participation than the one before.



Source: Department of Labor (Bureau of Labor Statistics).

Chart 4-7 **Full-Time and Part-Time Work Among Men Aged 60-61**
The fraction of men aged 60-61 who were working was the same in 1985 and 1997, but there was a shift from full-time to part-time work.



Source: Department of Labor (Bureau of Labor Statistics).

buyouts may also have contributed to increased work by pensioners. More workers now than in the past are able to spend their pension funds for other purposes, in advance of or at retirement. The shift to defined-contribution pension plans (discussed below) means that benefits are more often received in the form of a lump-sum distribution upon termination of a job, instead of as an annuity, as is typically the case in defined-benefit plans. Many workers spend these lump sums instead of rolling them over into another retirement account, thus reducing the funds available to them in retirement.

The rise in work among older persons may also be related to changes in the demand for labor. Employers may be becoming more willing to hire older workers, as the "baby bust" that followed the baby boom leads to labor shortages. Since 1980 the part-time wages of older men have risen relative to those of younger men. This has made part-time work more attractive to retirees.

If the long-term decline in the labor force participation rate among older men has indeed run its course, it could indicate a limit to the desire for more years of complete leisure at the end of life. Older people may want to continue using their skills, or to try something new, when they leave a career job while still relatively young and healthy (and to earn some income in the process). The growth of the service sector, where jobs are less physically demanding and schedules more flexible than in manufacturing, makes work at older ages more attractive today than in the past. Changes in pensions and Social Security rules, discussed below, have also removed many of the incentives to retire abruptly and completely.

If rising lifetime wages have been driving the long-term decline in labor supply of older men, we might expect that supply to level off in the coming decade, as the cohorts born after 1945, who came of age as wages stagnated in the 1970s, start turning 55. In other words, not only may their labor force participation rates remain more or less constant, but so may the share of these workers working full time, year round. Alternatively, an increase in labor force participation may combine with an increase in part-time, part-year work. Much will depend on employers' demand for older workers, as reflected in the wages, fringe benefits, and working conditions offered to them, and on the incentives built into pension and Social Security rules—pension incentives being a reflection of employers' demand for older workers.

INFLUENCES ON THE TIMING OF RETIREMENT

What factors enter into a worker's decision to retire sooner rather than later? Among the possible considerations are changes in wages and other compensation as one grows older, the structure of employer pensions and Social Security, the worker's health and the availability of health insurance coverage, and the influence of prevailing social norms. Although the effect of each factor cannot be quantified precisely, all play a role in the retirement decision.

Compensation

Wages on a given job do not tend to decline with age, nor should they be expected to: there is little evidence that productivity declines with age per se, in the absence of disability. Although clinical tests have found that manual dexterity declines with age, other skills improve, and older workers develop ways to compensate for whatever skill losses they do suffer. Wages do decline when older workers change jobs, but one cannot infer from this that age alone reduces productivity. Lower wages following a job change may be due to the loss of "firm-specific human capital"—such as seniority, knowledge of the organization, working relationships, or goodwill gained in the former workplace. It may also reflect the worker's choice to move to a position entailing less responsibility or less strenuous or stressful working conditions. Nevertheless, older workers who lose their jobs may opt to retire rather than accept the wage reduction that may accompany a job change.

The Availability of Social Security and Employer Pensions

The structure of Social Security and employer pensions may also influence the exact timing of labor force withdrawal. Certain Social Security rules (Box 4-2) create an incentive for many people to retire at age 62, the earliest age at which benefits are available for persons without disabilities. This is evident in the large drop in labor force participation of both men and women at age 62 (Charts 4-5 and 4-6) and in the spike in retirements among men at that age that has appeared since the mid-1960s, after early benefits were made available to men in 1961 (Chart 4-8).

Social Security has a number of conflicting effects on work incentives. On the one hand, the combined Social Security and Medicare payroll tax of 15.3 percent lowers the net wage, which by itself would tend to discourage work. On the other hand, more years of work could increase future benefits for some who have had years with little or no earnings, because substituting years of higher earnings raises one's average monthly earnings in the Social Security benefit formula. Future benefits are a form of deferred compensation, and increasing them tends to encourage work.

Apart from these features, the present value of expected Social Security benefits does not change for the average person, regardless of whether he or she begins to receive Social Security benefits at age 62 or at the normal retirement age (NRA). This is because the benefit increases by 8.3 percent per year that it is deferred (up to age 65), which is actuarially fair for a person with average life expectancy, and better than fair for someone with longer than average life expectancy. However, not everyone is average; many may not expect to live that long. For them, Social Security wealth decreases the longer they postpone benefits beyond age 62. This creates an incentive to begin taking benefits at 62 rather than later, for workers whose life expectancy is lower than the average.

Box 4-2.—Social Security Rules

The old-age, survivors, and disability insurance program of the Social Security system is designed to replace a portion of earnings lost because of retirement, disability, or death. It is financed by a dedicated tax of 12.4 percent on earnings in covered jobs, up to a maximum in 1999 of $72,600. That maximum is indexed each year to changes in the average wage. Formally, half the tax is levied directly on the employer, and half on the employee through payroll withholding, but it is generally agreed that, in an economic sense, the burden of the tax falls entirely on the worker. Self-employed workers pay the full tax.

Retirement benefits are based on a person's lifetime average indexed monthly earnings (AIME; the indexing reflects increases in national average wages) in covered employment. Only earnings up to the maximum taxable earnings in each year are counted. Before earnings are averaged, a certain number of years with the lowest (or zero) indexed earnings are dropped. The monthly benefit payable at the normal retirement age (called the primary insurance amount, or PIA) is calculated according to a progressive formula in which the replacement rate (the PIA as a percentage of average lifetime earnings) falls as lifetime earnings rise. Benefits are indexed to the consumer price index, and therefore have risen more slowly than average wages in the past two decades.

The normal retirement age (NRA) is the age at which one becomes eligible for a full retirement benefit. The NRA is currently 65 but is scheduled to rise gradually to 67, beginning with workers who will reach age 62 in the year 2000. Retirees may, however, begin receiving a permanently lower benefit as early as age 62. This minimum age for receiving benefits will remain at 62 even as the NRA rises. The benefit reduction is calculated to be actuarially fair (that is, it preserves the present value of expected benefits for a person with average life expectancy).

Between ages 62 and 70, receipt of both normal and actuarially reduced benefits is subject to a retirement earnings test. For persons below the NRA the annual benefit is reduced by $1 for every $2 of annual earnings above a certain exempt amount ($9,600 in 1999). For those between the NRA and age 70 the reduction is $1 for every $3 of annual earnings above a higher exempt amount ($15,500 in 1999). These exempt amounts are scheduled to increase in the future, and the President has proposed that this earnings test be eliminated entirely.

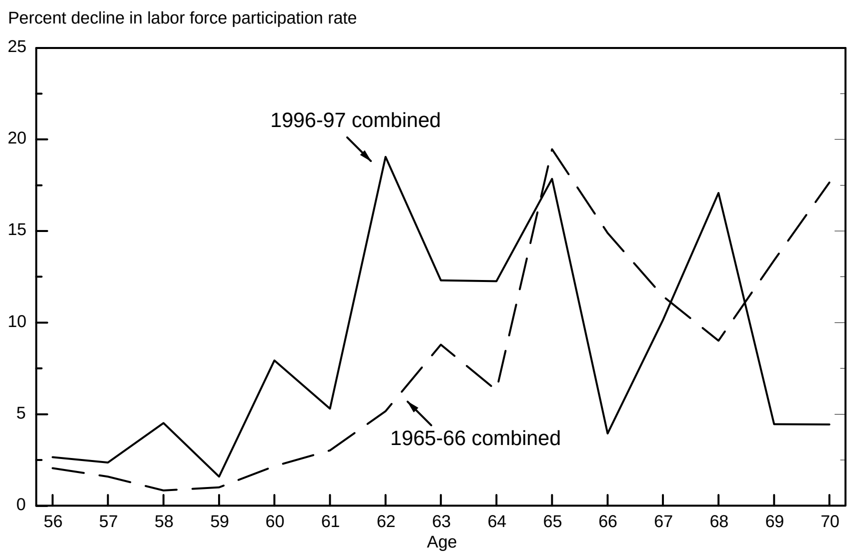
Persons who begin receiving retirement benefits before reaching the NRA and then earn more than the exempt amount, so that their benefits are reduced or completely withheld for a given

Box 4-2.—*continued*

month because of the earnings test, receive an actuarially fair increase in benefits when they reach the NRA. Thus, benefits lost are recovered later. Moreover, earnings from age 62 up to the NRA are considered in the AIME and may well increase the benefit one receives at the NRA. On the other hand, workers continue to pay the Social Security payroll tax, as well as income and other payroll taxes, as long as they work. From the NRA on, postponed benefits are increased by only 5.5 percent per year (for persons who reach age 65 in 1998-99), which is less than actuarially fair. However, this adjustment for delayed retirement is being gradually increased, in a process that began in 1990 and will continue until cohorts reaching the NRA in 2009 and after get an actuarially fair 8 percent per year for postponing benefits, up to age 70.

Those who discount future income at a higher rate than 8.3 percent may also want to start taking their Social Security benefits early. In particular, they may have a strong preference for current over future income because they are unusually "present oriented" or risk averse. Also, those who want to receive their Social Security benefits before the NRA need not leave the labor force entirely to do so. They can receive their full benefit as long as they keep their earnings under the exempt amount (see Box 4-2). However, part-time jobs are not always

Chart 4-8 **Net Labor Force Exit Rates of Men at Each Age**
The peak age at which men retire from the labor force has dropped from 65 to 62 in the past three decades.



Source: Department of Labor (Bureau of Labor Statistics).

available with the same hourly pay, benefits, and working conditions as full-time jobs, so that many may prefer to stop working completely rather than take a part-time job. Other individuals may wish to retire or work part time even before age 62, but cannot yet collect any Social Security benefits and do not have sufficient savings and pension income to live on. Because future Social Security income cannot be used as collateral for a loan, this creates an incentive to continue working until age 62. All of these considerations help to explain the spike in retirements at that age.

The fact that Social Security benefits deferred beyond age 65 are increased by only 5.5 percent per year (for workers aged 65 in 1998-99) means that Social Security wealth declines for a worker with life expectancy equal to or lower than the average who continues to earn more than the exempt amount beyond that age. As recently as 1989, the increase was only 3 percent per year. (See Box 4-2 for an explanation of this phased-in increase in benefits deferred beyond the NRA.) This provision has acted like an additional tax on earnings above the exempt amount that kicks in at age 65. Although the exempt amount is higher at ages above the NRA than below it, good part-time jobs may not be available for workers over age 65. The decline in Social Security wealth for persons whose earnings exceed the exempt amount at ages 65 and above has provided a special incentive to retire at that age, which is reflected in another drop in labor force participation and a spike in retirements at age 65 (Charts 4-5, 4-6, and 4-8). The rules governing private pension and Medicare benefits, as well as other social factors, also create incentives to retire at 65, as discussed elsewhere in this chapter.

Because the Social Security rules do not vary across persons in a given age group, it has been difficult to measure Social Security's effect on labor supply separately from other factors. One study used data for age groups that were subject to different exempt amounts from just before and after changes in the earnings test rules. The study found that the earnings of a substantial number of workers—over 20 percent of male workers aged 67-69, and nearly 10 percent of those aged 63-64—were clustered within $1,000 below the exempt amount. The cluster moved when the exempt amount moved. This study estimated that the effect of the earnings test is to reduce the average annual working hours of male workers aged 65-69 by about 4 percent. Only 28 percent of men (and 18 percent of women) in this age group are currently in the labor force, but more might seek jobs if the earnings test were completely eliminated, as the President has proposed.

In recent years the most common age for starting Social Security benefits has shifted from 65 to 62. Part of the explanation may be the continuing increase in lifetime income, which allows recent cohorts to retire earlier. Social norms may also be shifting, making it more acceptable for men to be idle before age 65. The decisions in 1956 and 1961 to make Social Security benefits available at 62 for women and men, respectively, may have both reinforced and expressed such a change in norms—in a democratic society, legislation often tends to follow social norms. The abolition in 1978 of mandatory retirement before age 70 (Box 4-3) may also have removed age 65 as the predominant focus for retirement planning.

Box 4-3.—Age Discrimination in the Labor Market

The Age Discrimination in Employment Act (ADEA) of 1967 outlawed age-based employment discrimination against both employees and job applicants who are 40 years of age or older. Later amendments prohibited mandatory retirement before the age of 70 (in 1978) and then outlawed mandatory retirement altogether (in 1986), with a few exceptions. A 1990 amendment prohibited employers from denying benefits to employees because of age.

The number of age-discrimination charges filed with the Equal Employment Opportunity Commission (EEOC) has fluctuated over the past decade between about 14,500 and 19,800 per year. That number remained fairly constant between 1987 and 1990, increased sharply in the early 1990s (reaching a high of 19,809 in 1993), and then fell substantially after 1994. In fiscal 1998, 15,191 such charges were filed. Of the charges filed that year, 12 percent had outcomes favorable to the party bringing charges.Most of the rest ended either with a ruling by the EEOC of no reasonable cause or for administrative reasons.

Incentives provided by employer pensions must also be considered in any effort to explain changing retirement patterns. Twenty years ago, most employer pensions were of the defined-benefit (DB) type (Box 4-4). Workers covered by such plans typically had strong incentives to retire before age 65, as early retirement benefits had a higher actuarial value. Defined-contribution (DC) plans, including those with 401(k)-like features, on the other hand, contain no incentives for early retirement, because pension wealth continues to grow until the funds are withdrawn. As these plans have become more widespread in the past 20 years, workers have been less constrained in their choice of retirement age.

Job Characteristics and Job Accommodation

For the elderly as for others, the effect of health problems on the ability to work, and thus on the decision to work or retire, depends on several factors. These include the type of job one has, the opportunities for accommodating health problems, and the opportunities to switch to

Box 4-4.—Types of Pension Plans

Under a defined-benefit plan, a worker qualifies for a pension benefit by working in a covered category (which may exclude certain types of workers, such as part-timers) for a given number of years. This period, called the vesting period, is now 5 years for the vast majority of workers in the private sector. The benefit is then available at a certain age and is usually calculated by multiplying a given percentage of final earnings by the number of years of service. About half of workers with DB pensions are in plans that are integrated with Social Security; that is, the pension benefit formula reduces the pension amount to adjust for expected Social Security benefits. Reduced benefits may be available at an earlier age. These benefits often have a higher actuarial value than normal retirement benefits, and this produces strong incentives to retire at a certain age. Most DB plans in the private sector are insured by the Federal Government (see Box 4-7).

By contrast, defined-contribution plans do not entail age-specific retirement or work incentives. DC plans are essentially tax-favored savings accounts to which employers may contribute, sometimes even if the employee does not also contribute. Examples of DC plans are savings or thrift plans, deferred profit-sharing plans, money purchase plans, employee stock ownership plans (ESOPs), and 401(k) arrangements. Benefit levels in DC plans are not guaranteed and are not federally insured. Instead, the funds are invested, often at the worker's direction, and the amount of the eventual retirement benefit depends on the amounts contributed and on the portfolio's performance over the years. Benefits are usually paid in a lump sum upon departure from the firm, although sometimes other options are available. These funds are usually portable; that is, they may be rolled over tax-free into another pension plan or an individual retirement account. Because the employer's obligation is limited to its financial contribution and the plans reduce administrative costs and enhance flexibility, they are popular with employers.

Section 401(k) of the tax code allows an employee of a for-profit firm to contribute a share of his or her cash compensation to a DC plan, and to defer taxes on both the initial contributions and the investment returns. Employees of nonprofit organizations, State and local governments, and Indian tribes can participate in similar tax-deferred annuity programs. Under most before-tax retirement savings plans, the employer matches a percentage of contributions, but Section 401(k) does not require employers to contribute in this manner. This chapter refers to all plans providing for *employee* contributions as "401(k)-type plans." Although 401(k)-type plans are popular DC plans, there are other types of DC plans that do not provide for tax-deferred employee contributions (for example, most money purchase pension plans and a substantial share of profit-sharing plans and ESOPs).

a less demanding job. There is no consensus on what constitutes a physically demanding job. One definition considers a job physically demanding if it entails regularly lifting objects that weigh at least 25 pounds. By this definition the share of older Americans employed in such jobs has fallen steadily, from 25 percent in 1950 (for those aged 60-64) to 7 percent in 1990. But other job requirements besides physical strength may make continuing work difficult for older workers. For example, about 90 percent of older workers say that their jobs require good eyesight and intense concentration.

Employers frequently accommodate the health impairments of their elderly workers. More than half of older workers who develop a new, health-related job limitation continue to work, and around half of those report that their employer has made some special accommodation for them. The most common types of accommodation involve changing the structure of the job, rather than making new investments in equipment or incurring other direct employment-related costs. Changes in job structure include changing the scope of the job (reported by 51 percent of those who have received accommodation), allowing more breaks and rest (45 percent), and providing assistance with certain aspects of the job (37 percent). Although the evidence is limited, accommodation rates appear to be similar for workers at all levels of education.

The direct cost of accommodating older workers with impairments appears to be small in most cases, with a median of about $200 per accommodation; 70 percent of accommodations cost less than $500. These estimates do not, however, take into account losses in productivity from changes in job scope and increased assistance from co-workers, nor, on the other hand, do they consider the cost saving of not having to hire and train a replacement worker.

Health Insurance and Retirement

Studies have found that the availability of health insurance to persons under 65 that is not contingent on working—either employer-provided retirement coverage or Medicare eligibility of a spouse—tends to increase a worker's likelihood of retiring. Widespread provision of retiree health benefits by employers may have contributed to the pre-1985 trend toward retirement before age 65, but its influence has diminished since then. The magnitude of the response and the role health insurance has played in retirement trends remain highly uncertain, however.

Between 1987 and 1996 the share of wage and salary workers aged 55-64 who were covered by health insurance from a current employer—their own or a nonelderly family member's—remained constant at 73 percent, despite increased availability of health insurance from employers. Although more workers in this age group were offered coverage, the takeup rate—that is, the fraction of offers accepted by the worker—declined. More of these older workers are getting their health coverage through a spouse's employer, as the share covered by health insurance from their own main job fell by 2.5 percentage points, to 61.7 percent. The share of employees aged 55-64 who had access to health insurance coverage through either their own or a family member's job rose from 78.5 percent to 80.4 percent. However, the share of those with access who actually were covered by health insurance dropped from 92.8 percent to 90.4 percent, possibly because of the increased cost of premiums to the worker. Many of the rest had other private or public health insurance, but the fraction of non-self-employed workers aged 55-64 who were uninsured increased by almost 3 percentage points, to 12.0 percent in 1996.

Many employers provide health insurance for their retired workers, although an increasing number are requiring the retiree to share the cost. In 1993, 45 percent of full-time workers in medium-size and larger firms had access to health benefits upon retirement that were at least partly paid for by their employer. This fraction had declined considerably between 1985 and 1988 but changed little since then. Virtually all of these workers could get coverage from their employer to bridge the gap between retirement and eligibility for Medicare at age 65, and some coverage would continue after that for all but a small percentage. However, the percentage of workers who would have to pay part of the cost of coverage increased dramatically from 1988 to 1993, from 46 percent to 61 percent of those offered coverage before age 65, and by a similar amount for those offered coverage from age 65 on. Nevertheless, by one estimate the annual employer cost per retiree soared by 34 percent in real terms between 1988 and 1992 alone, to $2,760 (in 1992 dollars).

Because a majority of employers do not offer health insurance coverage to their retirees, and some firms, especially smaller ones, do not even provide coverage to their active workers, a large and growing number of 55- to 64-year-olds have no health insurance. The number of uninsured people in this age group grew by 7 percent in 1997 alone. Persons in this age group are considerably more at risk of needing expensive medical care than younger people, and often they cannot obtain commercial health insurance or find it unaffordable. And unless they are disabled or poor, they are not eligible for public insurance such as Medicare or Medicaid. The President has therefore proposed to allow 55- to 64-year-olds to purchase Medicare coverage (Box 4-5).

UNEMPLOYMENT AND JOB LOSS

Unemployment is less prevalent among the elderly than among younger workers. In 1998 the unemployment rate among 20- to 24-year-olds was 7.9 percent, the rate for 25- to 54-year-olds was 3.5 percent, and the rate for 55- to 64-year-olds was lower still at 2.6 percent.

Box 4-5.—Medicare Reform

The Medicare program, like Social Security, reflects the Nation's commitment to provide for the needs of its older members, and to support disabled Americans of all ages. Reforming Medicare to protect its financial soundness and ensure that it provides high-quality care for its beneficiaries has been one of the Administration's top priorities. The President worked to include important Medicare provisions in the Balanced Budget Act of 1997, which paved the way for an increasingly broad array of innovative health insurance choices for beneficiaries and shored up the Medicare trust fund. The President has taken steps to enroll more lower income seniors in supplemental benefit programs that provide financial assistance in paying Medicare premiums and other health care costs not covered by Medicare. The President has also developed initiatives to provide new preventive care benefits, to assist beneficiaries whose managed care plans have left the program, and to reduce Medicare fraud.

Even with these reforms, the aging of the population and the continuing development of new medical treatments will lead to mounting cost pressures for the Medicare program in the years ahead. The President has proposed to reserve 15 percent of the projected Federal budget surpluses over the next 15 years for the Medicare trust fund, which would extend the program's solvency from 2008 to 2020. In addition, with the President's encouragement, the National Bipartisan Commission on the Future of Medicare was formed to consider reforms to address the difficult long-term problems facing the program. The Commission's report, due in March 1999, will be an important next step toward the Administration's goal of developing a bipartisan agreement that will preserve and strengthen Medicare for all Americans in the 21st century.

The rate was slightly higher, at 3.2 percent, for workers 65 and older. Older workers have historically had lower unemployment rates than younger workers, and these data show that the current employment situation for older workers is strong.

In addition to having lower unemployment rates, older workers are less likely to be displaced (that is, to have lost their job because of a plant closing, insufficient or slack work, abolition of their position or shift, or some other similar reason) than are workers in their 20s and 30s. This has been true in every year since national data on displacement first became available in 1984. (See Chapter 3 for a general discussion of displaced workers.) According to the latest survey, conducted in 1998, the displacement rate (the ratio of workers displaced anytime in the 3 years prior to the survey to total employment at the time of the survey) was about 13 percent higher for workers aged 25-34 than for those aged 55-64. The rate of displacement fell from the 1993-95 period to the 1995-97 period for all age groups. However, the decline was relatively small among older workers: the displacement rate fell 10 percent among those aged 55-64, compared with 21 percent among those aged 25-34.

Although the rate of job loss is lower among older than among younger workers, the cost of being displaced may be higher for workers in their late 50s and early 60s. Older displaced workers are much more likely to leave the labor force after job loss. Among workers displaced in 1995-97, 30 percent of 55- to 64-year-olds and 55 percent of workers 65 and older had left the labor force by 1998, compared with just 9 percent of workers aged 25-54. Presumably many of these older displaced workers retire following displacement. But among displaced workers who remain in the labor force, the share who are unemployed is higher among older workers. In addition, for workers who do find jobs after being displaced, wage losses are substantially higher among older workers than among younger ones. Thus, even if displacement is less likely among older workers, when it does occur it may be more costly.

THE UNPAID CONTRIBUTIONS OF THE ELDERLY

It is not easy to attach a dollar figure to the value of the many unpaid contributions made by the elderly to the economy and society. Nevertheless, it is important to acknowledge the wide range of productive activities in which they are engaged. According to a 1996 survey, 43.5 percent of the population over age 55 volunteered at nonprofit organizations and for other causes, averaging 4.4 hours per week per volunteer. Many quite elderly persons are part of this active corps of volunteers: almost 34 percent of those 75 years old and older reported volunteering. The settings in which older people volunteer are both formal and informal. For example, 65 percent of volunteers aged 55 or older reported serving with a religious institution, 22 percent volunteered with an educational institution, and 37 percent worked informally in their neighborhoods or towns.

Many older people need ongoing assistance because of functional limitations or cognitive impairments, yet do not need nursing home care. Instead they often receive informal care, typically from other elderly persons, including their spouses and children. This informal caregiving work is largely hidden, because it is for the most part performed in a nonpublic setting and is typically unpaid. The work may, however, be essential to the caregiver's family and to the financial stability of the household, as formal care arrangements may cause severe financial strain. The provision of assistance by family members and friends may also reduce the burden on publicly provided services (see Box 4-1 for a discussion of long-term care).

A 1992 survey found that 15.1 million Americans over the age of 55 were providing direct care to sick or disabled family members, friends, or neighbors. Twenty-eight percent of men and 29 percent of women aged 55 and over were caring for others, as were 22 percent of all persons aged 75 and over. The typical amount of caregiving was 5 hours per week, but 2.4 million caregivers spent 18 or more hours per week. And although the proportions of men and women who were caregivers were close to equal, the total number of female caregivers was greater because women outnumber men in the older population.

Grandparents, and even great-grandparents, are important sources of assistance to families. In some households children reside with a grandparent; in others one or more grandparents assist parents with caregiving in various ways. According to the 1992 survey, 14.2 million Americans over the age of 55 helped take care of their grandchildren or great-grandchildren.

The Bureau of the Census reports that in 1997, 3.9 million children, or 5.5 percent of all children, lived in a household maintained by a grandparent—a 76 percent increase since 1970. There were substantial increases in the number of households maintained by grandparents, with or without a parent present. Among children living in households maintained by grandparents, the greatest increases since 1970 were in households where one parent also resided. More recently, the number of grandchildren living with their grandparents without any parents present has increased most rapidly.

This increase in grandparents' assistance with the care of their grandchildren parallels the increase in single-parent families, but it may also be due in part to the increased financial pressures faced by young married couples, who struggle to meet the demands of careers while raising children. Grandparents also step in when parents cannot function adequately because of drug use, mental or physical illness, or incarceration, or when parents abuse or neglect their children.

THE ECONOMIC WELL-BEING OF THE ELDERLY

By almost any measure, the economic well-being of the elderly has improved tremendously over the past three decades. Income is the most widely used measure, but it is only a starting point, because it has several weaknesses as a measure of well-being. First, people are most concerned about the goods and services that income can buy—about consumption, in other words—not income per se. People save in some periods to finance their consumption in later periods. As a result, income may be higher or lower in one year than another even though consumption is similar in both years. This logic suggests that it is important to consider the consumption of the elderly, which is examined below. A second weakness of income as a measure of well-being is that families have different needs, depending on the number of people in the family, their ages, where they live, and so on. Thus, an income that would seem generous to one family might be barely adequate for another. A third weakness of the income measure is that some economic goods do not have an easily quantifiable monetary value and are therefore not recorded as income. Most important for the elderly, home ownership and medical insurance certainly increase well-being, yet they are not captured by measuring before-tax money income. As a result, two families with identical incomes and identical needs could have very different economic status: one might, for example, own a valuable home and have generous medical insurance coverage, whereas the other rents an apartment and has no insurance.

Because of these weaknesses, three other sets of indicators of well-being are examined here in addition to income: the poverty rate, indicators of wealth accumulation (including home equity), and indicators of health status. The poverty rate adjusts differences in income across families for disparities in family size and composition. Wealth provides a cushion for people to smooth their consumption over time and creates a buffer against adversities, such as health problems, that may require substantial expenditure. Finally, earlier in this chapter changes in health status and life expectancy were examined, which are also important measures of well-being.

Most of the national data used to examine families' economic status are based on surveys of the noninstitutionalized population. This limitation is not of great importance when examining older workers, or even all persons over 65—only 5 percent of the elderly live in an institution (typically a nursing home). However, the proportion of institutionalized elderly rises sharply with age, to almost one-fourth of all persons 85 and over. Older persons in institutions typically have few economic resources and are in poor health. Therefore, findings from surveys of the noninstitutionalized population will not necessarily apply to the oldest old. Box 4-6 examines changes in living arrangements of the elderly during the 20th century, with a focus on widows.

INCOME AND CONSUMPTION

The Three-Legged Stool

Economic security in old age is often described as a three-legged stool, the legs being Social Security benefits; income from accumulated assets, including savings and home ownership; and pension income. But the notion of a stool with three legs of roughly equal size is misleading. The importance of each source of income varies tremendously among the elderly—many Americans depend almost entirely on Social Security, for example. In addition, for many elderly households labor market earnings provide a fourth leg to the stool. Moreover, the

Box 4-6.—The Changing Living Arrangements of the Elderly

Through most of history, the family has played an important role in providing support to the needy elderly. Shared housing can be an especially important and intensive form of support, and the past century has seen tremendous changes in living arrangements among the elderly. These changes have been particularly striking among elderly widows, who now account for 27 percent of all persons over 65.

The share of elderly widows living alone stayed roughly constant at a low level—10 to 15 percent—for several decades until about 1940 (Chart 4-9). Between 1940 and 1980, however, that proportion increased sharply, and the share living with adult children fell. By 1980, 59 percent of elderly widows were living by themselves, and only 22 percent shared a home with their children. This strong upward trend in widows' independence ended in 1980: living arrangements in 1990 were similar to those observed in 1980. It is estimated that rising economic status, primarily due to wider coverage and more generous benefits from Social Security, accounted for 62 percent of the increase in the share of elderly widows living alone between 1940 and 1990. About 9 percent of the change was explained by a decline in the number of children available for widows to move in with.

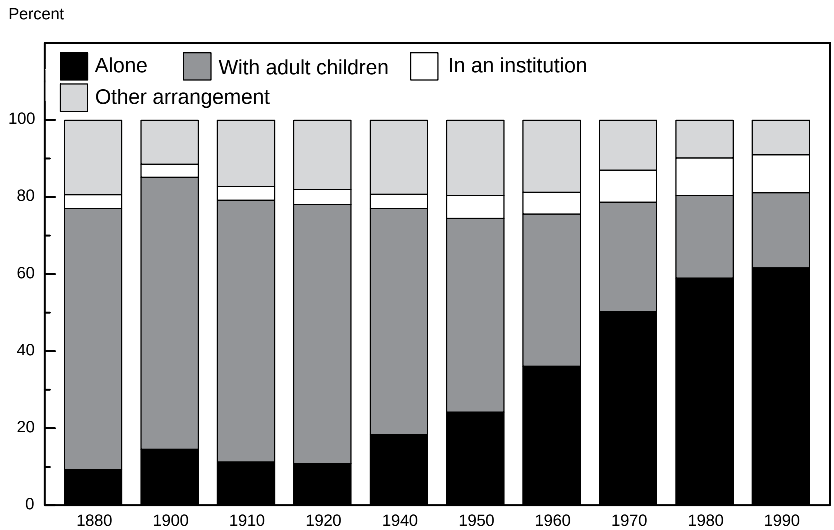
When elderly people have been asked to express their attitudes about living arrangement options in the event they needed care, 68 percent say they would like to receive assistance in their own home, and only 20 percent state that they would like to move in with relatives. Apparently, improvements in widows' economic status have allowed them to fulfill this desire to live independently. But despite these gains, poverty remains relatively high among widows (see Table 4-4).

average share of income from each source has changed over time and may continue to change in the future.

In 1962, before the sharp increases in Social Security benefits of the late 1960s and early 1970s, Social Security accounted for 31 percent of income for the elderly and their spouses; asset income accounted for 16 percent, and pension income was 9 percent. Earnings were also important at 28 percent. The remaining 16 percent of income included welfare and all other sources of income.

Income from these sources has grown at different rates in the past 30 years (Chart 4-10; income data refer to before-tax money income, the official Census Bureau definition, unless otherwise noted). The share provided by Social Security has increased, to 40 percent of income on average in 1996, whereas pensions and asset income each

Chart 4-9 **Living Arrangements of Elderly Widows**
Between 1940 and 1990, the share of elderly widows living alone increased sharply, and the share living with adult children fell.



Source: Kathleen McGarry and Robert Schoeni, "Social Security, Economic Growth, and the Rise in Independence of Elderly Widows in the 20th Century," National Bureau of Economic Research Working Paper No. 6511, 1998.

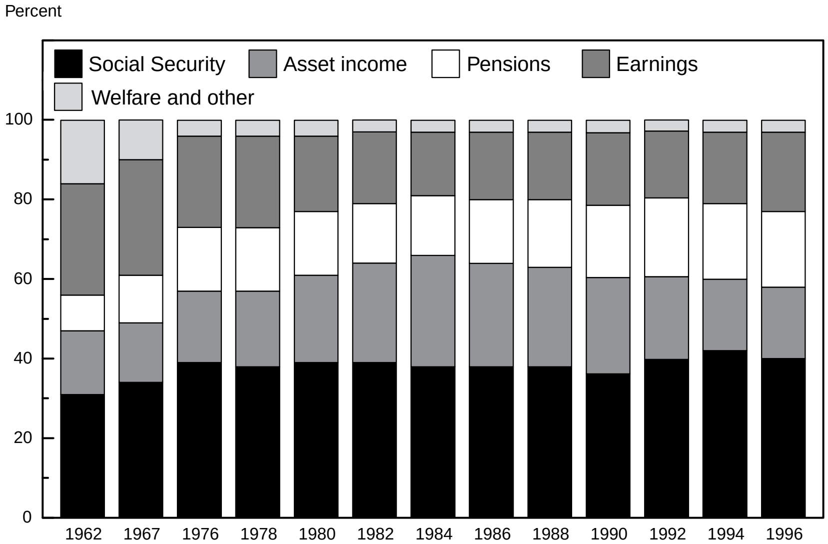
composed about one-fifth of income. The share of income comprised of labor earnings has declined substantially, as is to be expected given the decline in elderly labor force participation during this period. These changes took place during a period when the median incomes of both married and single elderly persons nearly doubled.

The composition of income looks quite different at different income levels. Among elderly households in the bottom fifth of the income distribution in 1996, Social Security accounted, on average, for 81 percent of income, public assistance for 11 percent, and asset income and pensions for only 3 percent each (Chart 4-11). Clearly, a large segment of the elderly have saved relatively little for their retirement. Elderly households in the top quintile of the income distribution rely fairly evenly on Social Security, asset income, pensions, and labor market earnings.

Saving Social Security

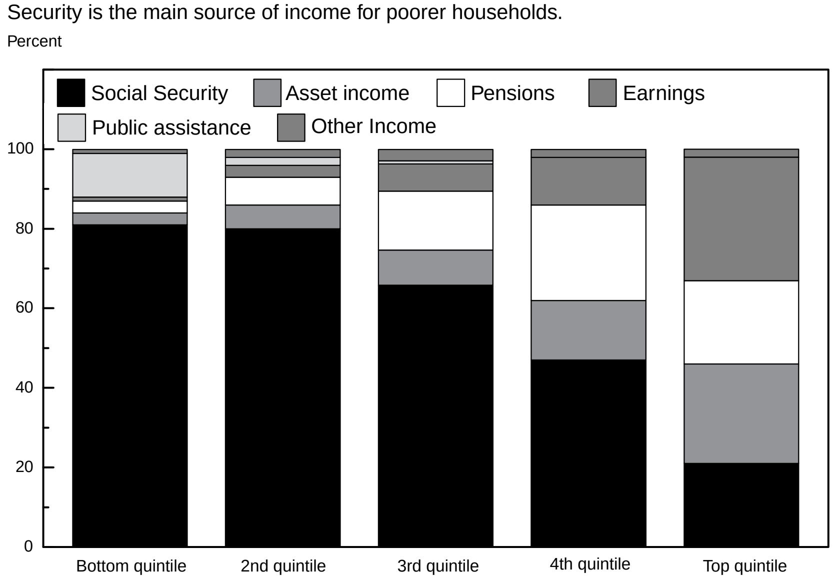
Social Security plays an important and unique role among the sources of income for the elderly. As discussed in Chapter 1, it is a family protection plan as well as a pension system, providing Americans for more than half a century with income in retirement and protection against loss of family income due to disability or death. In particular, by providing a lifetime annuity, it offers a level of income security difficult to obtain in private markets. Through its special contribution to the well-being of the elderly, survivors, and the disabled, Social Security has been an extremely successful social program. Yet the demographic pressures of population aging,

Chart 4-10 **Composition of Income Among the Elderly**
The share of income from earnings has declined over time for persons aged 65 and older and their spouses, while the share from pensions has increased.



Note: Data are for elderly persons and their spouses.
Source: Department of Commerce (Bureau of the Census).

Chart 4-11 **Composition of Income by Quintile Among the Elderly, 1996**
The composition of income differs for lower versus higher income elderly. Social Security is the main source of income for poorer households.



Note: Data are for elderly persons and their spouses.
Source: Department of Commerce (Bureau of the Census).

mentioned earlier in this chapter and discussed at greater length in the 1997 *Economic Report of the President*, will require forward-looking action from policymakers to preserve the program's financial viability in the first quarter of the next century and beyond. Chapter 1 describes the President's proposals to do this.

From Defined-Benefit to Defined-Contribution Pension Plans

An important source of income for many elderly is employment-related pensions. The past 20 years have seen dramatic changes in the prevalence of the two main types of pension plans. Defined-contribution plans, including 401(k)-type plans, have gained in popularity as participation in defined-benefit plans has declined (Table 4-1; see also Box 4-4 for a discussion of the two types of plans). The portability of DC plans favors mobility among jobs, and workers' demand for more-portable benefits may have contributed to the ascendance of these plans. DB plans are more prevalent in unionized manufacturing firms and in the public sector, both of which have seen a decline in their share of the work force, thus contributing to the decline in DB participation rates. Before passage of the Employee Retirement Income Security Act (ERISA) in 1974 (Box 4-7), employees in DB plans were exposed to the serious risk that their employers would underfund the plan or divert its funds to other purposes. Even with the protections afforded by ERISA against underfunded DB plans, DC plans have become increasingly popular, suggesting that workers have come to accept the investment risks inherent in these plans in exchange for their flexibility. Benefits in DC plans depend on uncertain investment returns, whereas DB retirement benefits are more certain because they are usually tied to years of employment according to a known formula. Many workers are in DC plans that supplement a DB plan, but almost all of the recent growth in DC participation has been among workers who do not have DB plans.

The growing prevalence of DC, and especially 401(k), plans represents a major shift of responsibility for providing for retirement income from the employer to the worker, making the provision of retirement income more and more like individual (albeit tax-advantaged) saving. Concomitantly, the trend toward DC plans has shifted certain risks between employer and worker. Under a DB plan, the nominal benefit amount is guaranteed at retirement, and the employer bears the risk of providing this amount. The worker has no control over how the pension fund is invested. Moreover, a worker's pension is at risk if he or she changes jobs. Since there typically is no provision for worker contributions, workers usually receive nothing at all from jobs that end before the vesting period is completed. Finally, because benefits for vested employees are determined in nominal terms when employment terminates, inflation may drastically erode a pension's purchasing power by the time a separated worker reaches retirement age.

TABLE 4-1.—*Estimated Pension Coverage and Offer Rates for Private Sector Wage and Salary Workers*

Year	Percent of workers covered by a			Percent of workers offered a 401(k)-type plan[2]
	Primary defined-benefit plan[1]	Primary defined-contribution plan[1]	401(k)-type plan[2]	
1981	37	9	(3)	(3)
1982	36	10	(3)	(3)
1983	35	11	3	7
1984	34	11	(3)	(3)
1985	33	13	(3)	(3)
1986	32	14	(3)	(3)
1987	31	15	(3)	(3)
1988	30	15	14	25
1989	29	16	(3)	(3)
1990	28	17	(3)	(3)
1991	27	18	(3)	(3)
1992	26	20	(3)	(3)
1993	26	20	23	35
1994	24	21	(3)	(3)
1995	23	23	(3)	(3)

[1] For workers covered under both a defined-benefit and a defined-contribution plan, the defined-benefit plan is designated as the primary plan unless the plan name indicates it provides supplemental or past service benefits.
[2] All plans providing for tax-deferred employee contributions, whether or not the employer also contributes.
[3] Not available.

Source: Department of Labor (Pension and Welfare Benefits Administration).

Most private 401(k)-type DC plans, on the other hand, rely on worker contributions for at least a portion of benefits. The worker typically decides how much to contribute and where to invest the funds (within certain limits). Although workers have greater control over investments in DC plans, they also bear the risk of variable returns on those investments, in marked contrast to DB plans. Because there is no vesting period for *employee* contributions in either type of plan, they belong to the worker from the start. Employers often make matching contributions to 401(k) plans, which belong to the worker once the vesting period is completed. A job change need not affect the worker's accumulation, provided the worker leaves the funds in the account or rolls them over into a new tax-deferred account. However, only a third of those aged 45-54 in 1993 who had received a lump-sum pension distribution had put it into a retirement account; fewer than half had put it into any financial asset. Of those aged 25-34, only 25 percent had put their lump sums into financial assets, including retirement accounts.

Less wealthy, lower income, and less educated workers tend to be more risk averse in their investment choices; that is, they tend to invest in more conservative, fixed-income securities rather than in stocks. By taking less risk (other than inflation risk), they earn lower long-run rates of return on average and therefore tend to end up with smaller accumulations at retirement than do higher income, wealthier

Box 4-7.—The Federal Role in Employer-Provided Pension Plans

The Employee Retirement Income Security Act of 1974 governs pension and welfare plans sponsored by private employers. The act covers both defined-benefit and defined-contribution plans. ERISA was enacted because of concerns about the private pension system: that too few employees were receiving or would receive the pensions they had come to expect; that too many participants were being treated unfairly by plans and employers; and that existing law was inadequate to deal with these problems. Title I of the act spells out the protections it provides for workers and fiduciary standards for employers, trustees, and service providers. Title II sets forth standards that plans must meet in order to qualify for favorable tax treatment, and Title III contains administrative provisions. Title IV, which is carried out by the Pension Benefit Guaranty Corporation, a Federal agency, regulates employers' funding of their plans to make sure they set aside sufficient funds to pay the promised pensions. It also insures vested participants' pensions, at least up to certain levels, against the eventuality that the employer cannot pay.

This Administration has worked for continued pension reform to promote retirement saving. Many of the President's proposed pension provisions were adopted in the Minimum Wage Increase Act of 1996. That act expanded pension coverage in several ways. It created a new 401(k)-type plan for small businesses, with a simple, short form intended to make it easier for small businesses to provide their workers with pensions. It made it easier for employers to let new employees participate in 401(k) plans immediately. It required State and local government retirement savings plans to be held in trust so that employees do not lose their savings if the government declares bankruptcy. It expanded access to 401(k)-type plans to employees of nonprofit organizations and Indian tribes. And it promoted portability for veterans by allowing reemployed veterans and their employers to make up for pension contributions lost during active service.

More recently, the Administration has proposed a number of initiatives to address concerns about women's pension arrangements. One proposal would allow time taken under the Family and Medical Leave Act to count toward eligibility and vesting. For some workers such a provision could make the difference between receiving or not receiving credit toward minimum pension vesting requirements for an entire year of work (a minimum amount of work is required in a given year for it to count toward the vesting period). Another would address the needs of widows by requiring

Box 4-7.—*continued*

employers to offer an option that pays a survivor benefit to the nonemployee spouse equal to at least 75 percent of the benefit the couple received while both were alive, in exchange for a smaller benefit while both are alive. This option would give the surviving nonemployee spouse the security of a larger benefit than otherwise, which may better reflect the cost of living for one person compared with two. This would improve the protection provided by the Retirement Equity Act of 1984, which requires that pensions be paid in the form of a joint life annuity in which the surviving nonemployee spouse receives at least 50 percent of the benefit received while both spouses were living, unless the retiree's spouse signs a consent to have the pension paid in some other form, such as a lump sum or a single life annuity.

individuals with the same contributions, although their return is also more certain. At least partly because they have lower incomes and less wealth on average, blacks and women make more conservative investment choices, and consequently would tend to accumulate even less in a DC plan that provides for employee-directed investments, compared with white men, than their lower contributions alone can account for. They also are more likely to cash out their lump-sum distributions when changing jobs.

It is important to distinguish risk aversion based on lower income and wealth from risk aversion based on lack of knowledge and investment experience. Those who have fewer resources to cushion potential losses cannot afford to take as much risk as those with more to spare. This is a perfectly sound reason for avoiding risk. However, if lower income groups are choosing assets with less risk and correspondingly lower expected yields out of lack of knowledge, or because they misperceive the amount of risk involved in higher yielding assets, the policy implications are different. Of course, income, wealth, education, experience with investments, and knowledge of investment principles are correlated with each other. Women also may have less knowledge of investments because husbands have traditionally taken care of these financial matters for the family, although this is no doubt changing as family structure and roles within the family change. There is an urgent need to educate all workers about investments so that, if they are managing 401(k) investments, they have a better chance of achieving their retirement income goals.

Depending on what happens to coverage and participation rates and to average contributions and rates of return, the DC "revolution" could either increase or reduce the average pension income of older Americans. But the movement toward DC plans could result in greater inequality among retirees who have the same job tenure. Under a DB plan that bases benefits on pay and years of service and is not integrated with Social Security (as explained in Box 4-4), the pensions of workers with the same years of service will differ only in proportion to their pay. Under a DC plan, however, their pensions will differ according to the difference in investment returns (compounded) as well as in proportion to pay. If the difference in returns is positively correlated with pay, the inequality of retirement income will be magnified. Moreover, contribution rates may be more unequal in 401(k) plans, because they are partly or wholly chosen by the employee (subject to certain rules and dollar limits, which may be especially restrictive for higher paid employees). In most DB plans, benefit levels are determined by the employer (also subject to certain rules and limits).

It is difficult to predict the effect of the shift from DB to DC plans on the average pension incomes of women and minorities relative to white men. Because women earn less on average than men, and minorities earn less than whites, the pensions of women and minorities are smaller on average under either type of plan. The evidence is that, for people aged 51-61 in 1992, the male-female differential in accumulated pension wealth from *all* jobs was smaller in DC than in DB plans, even though the male-female differential in accumulated pension wealth on the *current* job was greater in DC plans (Table 4-2). These data on pension wealth do not, however, control for possible differences in earnings, job turnover, and tenure between participants in DC and DB plans.

One might expect gender and racial gaps to be greater in DC plans at a given date on the workers' *current* jobs because white men tend to have longer job tenure than women and blacks. In DC plans, pension benefits grow exponentially with tenure, because the contributions earn a compound rate of return, whereas in most DB plans benefits increase only proportionally with years of service and salary (unless benefits are integrated with Social Security). A dollar invested each year at 4 percent annual interest is worth $12.48 after 10 years and $30.97 after 20 years. Therefore, at a given date, a worker who has been in a DC plan for 20 years will have 2.48 times the accumulation of a worker who has been in the plan for only 10 years, even if they made exactly the same contribution to their accounts in each year they participated in the plan. In most DB plans that are not integrated with Social Security, the worker who separates after 20 years of service would receive only twice the benefit of an equally paid worker who separates at the same time after 10 years of service.

However, when pension wealth from *all* jobs is considered, the gender and racial gaps may be *smaller* in DC plans because they do not penalize job turnover and intermittent labor force participation as much as DB plans do. This depends crucially, however, on whether the DC funds are left to grow rather than withdrawn and spent when jobs

TABLE 4-2.—*Gender Differences in Pension Wealth, 1992*

Kind of pension plan	Percent with pension wealth		Ratio of male to female median individual pension wealth
	Women	Men	
From all jobs during lifetime:[1]			
Defined-benefit	31	54	2.2
Defined-contribution	28	38	1.7
On current job only:[2]			
Defined-benefit only	31	30	1.3
Defined-contribution only	22	21	2.7
Both	16	24	2.1

[1] Self-reported for all lifetime jobs, all nonretired non-self-employed respondents aged 51-61 in 1992 who worked since 1982.

[2] Pension providers' administrative records for current job only, currently employed respondents aged 51-61 in 1992.

Source: Health and Retirement Survey, Wave 1. For lifetime jobs data, custom tabulations by Marjorie Honig, October 1998; for current job data, Richard W. Johnson et al, "Gender Differences in Pension Wealth: Estimates Using Provider Data," unpublished paper, August 1998.

end. And as we have seen, many recipients of lump-sum payments do spend them rather than roll them over.

DB plans provide benefits in the form of an annuity, which guarantees an income for life, unless the plan provides, and the participant elects, a lump-sum payment option. The optional forms of annuity and lump sum are calculated using a uniform mortality table for all races and both sexes combined, so that participants do not receive different monthly benefits simply because of their race or sex. However, whites (and Hispanics) and women have longer remaining life expectancies at age 55 than blacks and men, respectively, and so receive the stream of benefits over a longer period of time, on average.

The accumulation in a DC plan, on the other hand, does not depend on life expectancy. But participants in DC plans cannot assure themselves a guaranteed income for life, unless their plan provides a group annuity option or they purchase an annuity on their own. DC plans thus pose the risk that the beneficiary will outlive his or her savings. The private market for annuities is subject to adverse selection, in that those who expect to live a long time are more likely to purchase annuities, and this drives up their price. This works to the disadvantage of women in DC plans, since they are more likely than men to live long enough to run out of money if they do not have an annuity.

Finally, market forces may cause wages to adjust to differences in employers' pension costs, so that workers who get more deferred pension compensation in one type of plan may "pay" for this benefit in the form of lower wages, or their wages may grow more slowly with time on the job. All of these considerations leave it an open question whether minorities and women are likely to be better off relative to white men in DB or DC pension plans.

Consumption

The economic status of the elderly is ultimately measured by the standard of living that they enjoy. Elderly households typically spend less on consumption than younger households (Table 4-3), in part because the average elderly household has fewer people. But the three largest expenditure categories for elderly households are the same as those for younger ones, namely, housing, transportation, and food. As is well known, health care accounts for a greater share of expenditure for elderly households than for younger ones: 11.7 percent versus 4.2 percent.

TABLE 4-3.—*Consumption Patterns of Elderly and Nonelderly Households by Age of Household Head, 1997*

Item	Percent of total expenditures		
	All households	Head under 65	Head 65 and over
Housing	32.4	32.3	33.1
Transportation	18.5	19.0	15.6
Food	13.8	13.7	14.3
Personal insurance and pensions	9.3	10.2	3.9
Health care	5.3	4.2	11.7
Entertainment	5.2	5.3	4.5
Apparel and services	5.0	5.1	4.3
Cash contributions	2.9	2.4	5.4
Miscellaneous	2.4	2.4	2.5
Education	1.6	1.8	.6
Personal care products and services	1.5	1.5	1.8
Alcoholic beverages	.9	.9	.8
Tobacco and smoking	.8	.8	.6
Reading	.5	.4	.7
AVERAGE DOLLAR EXPENDITURES	$34,819	$37,543	$24,413

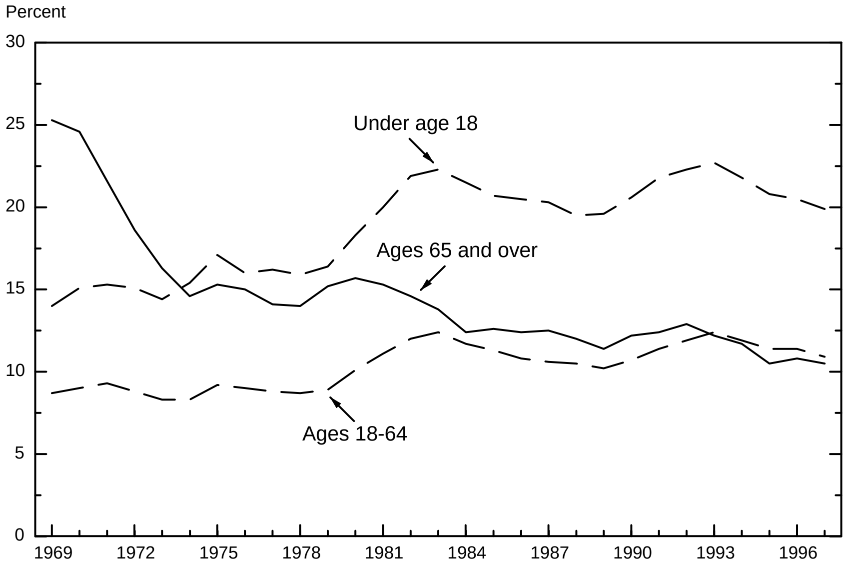
Source: Department of Labor (Bureau of Labor Statistics).

POVERTY

The reductions in poverty among the elderly in recent decades have been remarkable: in 1970, 25 percent of all persons over 65 were living in poverty, but in 1997 only 11 percent were poor (Chart 4-12). Much of this improvement occurred in the early 1970s, in part because of double-digit percentage increases in Social Security benefits enacted in 1971, 1972, and 1973. But progress has been made since then as well: elderly poverty has fallen by 28 percent in the last 15 years alone, and since 1993 it has declined by 14 percent.

Many elderly people, however, live just above or just below the poverty line; relatively small changes in their income could move them

Chart 4-12 **Poverty Rate by Age Group**
Poverty among the elderly has declined dramatically, from 25 percent in 1969 to 11 percent in 1997.



Source: Department of Commerce (Bureau of the Census).

into or out of poverty. In 1997, 6.4 percent of the elderly were “near poor”; that is, their before-tax money income placed them above the poverty line but below 125 percent of that line. Another 5.9 percent had incomes below, but at least 75 percent of, the poverty threshold.

The decline in poverty among the elderly has been experienced across demographic groups: men and women, whites and blacks, younger as well as older elderly persons, and married as well as single persons (Table 4-4). In particular, poverty among black elderly persons has fallen from 48.0 percent to 26.0 percent since 1970, while the rate for whites has fallen from 22.6 percent to 9.0 percent. And poverty among widows has been reduced by half during the same period, with a decline of almost 3 percentage points between 1993 and 1997.

At the same time, Table 4-4 highlights the tremendous variation in the income status of the elderly, and the fact that poverty remains high for several groups. Poverty rates for elderly women are nearly twice as high as those for elderly men, and 72 percent of all elderly living in poverty are women (Table 4-5). Widows, who account for roughly half of all elderly women, have an especially high rate of poverty, at 17.9 percent. The President has proposed to address this problem as part of the ongoing discussions to save Social Security.

Identifying the Needy Population

Who are the elderly living in poverty? The majority of impoverished elderly are single—either widowed, divorced, or never married

TABLE 4-4.—*Poverty Rates Among the Elderly for Various Demographic Groups*

[Percent]

Year	Men	Women	Whites	Blacks	Widows	Ages 65-79	Ages 80 and over
1970	19.0	28.4	22.6	48.0	36.8	23.0	31.1
1980	11.0	19.1	13.6	38.1	25.1	14.2	22.6
1990	7.6	15.4	10.1	33.8	21.4	10.5	18.6
1993	7.9	15.2	10.7	28.0	20.7	10.7	17.7
1997	7.0	13.1	9.0	26.0	17.9	9.7	13.4

Source: Council of Economic Advisers tabulations of March Current Population Survey data.

(Table 4-5). Just over half (51 percent) are widows or widowers. Seventy-two percent of the elderly poor are women, compared with only 56 percent of the nonpoor elderly. Although elderly persons from minority groups are more likely to be in poverty than elderly whites, whites account for two-thirds of the elderly poor. Finally, as shown in Table 4-4, poverty is more widespread among the oldest old than among younger elderly persons. However, only 13.7 percent of all elderly persons in poverty are 85 or older (Table 4-5).

Alternative Measures of Income and Poverty

The income measure above can be broadened to include other factors that affect well-being, including taxes, noncash benefits (such as food stamps), and the imputed amount that would have to be paid if homeowners rented their home. If all of these factors are

TABLE 4-5.—*Sociodemographic Characteristics of the Poor and Nonpoor Elderly Population, 1997*

[Percent]

Characteristic	Elderly in poverty	Elderly not in poverty
Age		
65-74	48.6	56.6
75-84	37.7	34.9
85 and over	13.7	8.6
Female	71.8	56.2
Marital status		
Married/separated	28.1	59.9
Widowed	51.2	30.3
Divorced	12.3	6.0
Never married	8.5	3.8
Race/ethnicity		
Non-Hispanic white	67.2	88.6
Non-Hispanic black	21.0	7.0
Hispanic	11.7	4.4

Source: Council of Economic Advisers tabulations of March 1998 Current Population Survey data.

included, the elderly appear to be in better shape than if these factors are excluded. Average before-tax income for all households headed by someone 65 or older was $31,269 in 1997. Adding net capital gains ($1,116, on average) and subtracting taxes ($4,033, on average) leads to average after-tax income of $28,352. Adding in noncash government transfers ($153), imputed rent ($4,274), and employer-provided health insurance ($321) increases the value to $33,100. Benefits that are not included in this calculation are the values of Medicare and Medicaid, which are substantial but difficult to determine. These calculations demonstrate that a broader accounting of income available for consumption suggests that before-tax cash income underestimates monetary well-being by an average of a minimum of $1,831 (because Medicare and Medicaid are not valued), or 5.5 percent.

As described earlier, an alternative measure of well-being is consumption, or how much people spend on goods and services. It has been shown that the trends in “income poverty” and “consumption poverty” are similar: consumption poverty among the elderly was 84 percent higher, and income poverty 70 percent higher, in 1972-73 than in 1988.

WEALTH

Wealth holdings allow families to maintain consumption when earnings and income are low. Wealth includes financial assets such as savings accounts, stocks, bonds, and mutual funds, as well as nonfinancial assets such as homes, vehicles, and businesses. Table 4-6 reports the share of families holding each of these types of assets and, for those holding that asset, its median value as of 1995.

The vast majority of the elderly—over 90 percent—have at least some assets. Among elderly families holding financial assets, the median value in 1995 was roughly $20,000. Median values of nonfinancial assets varied by age: elderly families headed by 65- to 74-year-olds had greater median nonfinancial assets ($93,500) than did those whose head was 75 or older ($79,000); the family home was the most important nonfinancial asset across age groups. Financial wealth is commonly held in the form of retirement accounts: 35 percent of families headed by a 65- to 74-year-old held such an account, with a median balance of $28,500. In 1995 fewer than 15 percent of elderly families held mutual funds outside retirement accounts, although those who did have accounts had substantial holdings, on average.

Wealth holdings among the elderly vary enormously (Table 4-7). In 1994, 10 percent of all households with a member aged 70 or older had $162 or less in total wealth (in 1996 dollars), and at least that many had no financial assets at all. Another 20 percent had no more than $541 in financial assets and less than $30,311 in total wealth. At the same time, 10 percent had at least $415,622 in total wealth, with at least $175,341 in financial assets.

TABLE 4-6.—*Family Holdings of Financial and Nonfinancial Assets, by Age of Head of Family, 1995*

Type of asset	Percent of families holding assets			Median value among holders (thousands of dollars)		
	All families	Age of head		All families	Age of head	
		65-74	75 and over		65-74	75 and over
FINANCIAL ASSETS	90.8	92.0	93.8	13.0	19.1	20.9
Transaction accounts	87.1	91.1	93.0	2.1	3.0	5.0
Certificates of deposit	14.1	23.9	34.1	10.0	17.0	11.0
Savings bonds	22.9	17.0	15.3	1.0	1.5	4.0
Bonds	3.0	5.1	7.0	26.2	58.0	40.0
Stocks	15.3	18.0	21.3	8.0	15.0	25.0
Mutual funds	12.0	13.7	10.4	19.0	50.0	50.0
Retirement accounts	43.0	35.0	16.5	15.6	28.5	17.5
Life insurance	31.4	37.0	35.1	5.0	5.0	5.0
Other managed	3.8	5.6	5.7	30.0	26.0	100.0
Other financial	11.0	10.4	5.3	3.0	9.0	35.0
NONFINANCIAL ASSETS	91.1	92.5	90.2	83.0	93.5	79.0
Vehicles	84.2	82.0	72.8	10.0	8.0	5.3
Primary residence	64.7	79.0	73.0	90.0	80.0	80.0
Investment real estate	17.5	26.5	16.6	50.0	55.0	20.0
Business	11.0	7.9	3.8	41.0	100.0	30.0
Other	9.0	8.9	5.4	10.0	16.0	15.0

Source: 1995 Survey of Consumer Finances.

The 1998 *Economic Report of the President* described in detail the gaps in earnings and income between races and ethnic groups. However, these disparities are small relative to the differences in wealth. The median household income of elderly whites is about twice that of elderly blacks and Hispanics, but the comparable ratio for wealth is about five to one. Gaps in holdings of financial assets are even wider. In fact, as Chart 4-13 shows, median financial wealth for households with a member 70 or older is zero for blacks and Hispanics. This means that over half of the members of these groups have no financial assets at all; the only wealth they have consists of their home or other physical assets. This result holds for those approaching retirement age as well: over half of households that contained a black or Hispanic person aged 51-61 had no financial assets in 1992.

In sum, a large share of the elderly have very little wealth, and what wealth they do have is mostly in the form of housing and other illiquid assets, not financial assets. At the same time, a significant share of elderly people have quite large wealth holdings, including ample financial assets.

ARE OLDER WORKERS SAVING ENOUGH FOR RETIREMENT?

One reason why it is important to know the level of wealth holdings of older persons is to determine whether they will have enough resources in retirement. Answering this question is difficult for a

TABLE 4-7.—*Total and Financial Wealth of Households by Percentiles*

[1996 dollars]

Percentile	With member aged 51-61[1]		With member aged 70 and over[2]	
	Total	Financial	Total	Financial
10	1,115	-1,338	162	0
30	45,705	1,115	30,311	541
50	111,809	15,607	84,206	8,659
70	222,950	55,738	166,682	41,995
90	585,690	208,459	415,622	175,341
95	964,259	367,868	669,974	313,882
Mean	269,946	81,779	177,678	65,116

[1] Data are for 1992.

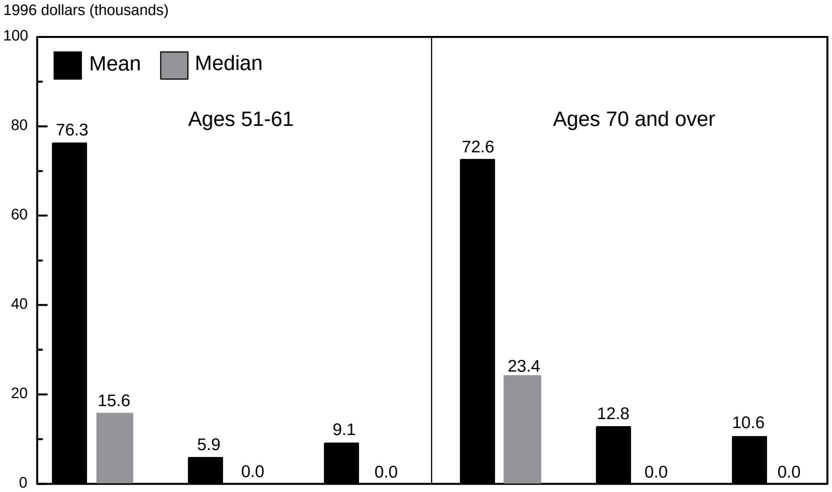
[2] Data are for 1994.

Note.— Total wealth includes equity held in homes, value of business and other tangible assets, and a detailed list of financial assets.

Source: James P. Smith, "The Changing Economic Circumstances of the Elderly: Income, Wealth, and Social Security," Center for Policy Research, Syracuse University, 1997.

Chart 4-13 **Household Financial Wealth by Race and Ethnicity**

Among older Americans, financial wealth is much higher for whites than for blacks or Hispanics. Over 50 percent of blacks and Hispanics have no financial wealth.



Note: Data are for households with a member of the given age. Data for ages 51-61 are for 1992 and data for ages 70 and older are for 1994.

Source: James P. Smith, "The Changing Economic Circumstances of the Elderly: Income, Wealth, and Social Security," Center for Policy Research, Syracuse University, 1997.

variety of reasons, including the fact that life expectancy, future interest rates, streams of income, and needs during retirement are highly uncertain. Moreover, to address this question one must first define what one means by "enough." Recent studies have defined "enough" as the amount of resources that preretirees need to maintain their current standard of living throughout retirement. These studies take into account the fact that the postretirement income needed to maintain the preretirement standard of living is smaller than the amount needed prior to retirement.

There is evidence that a significant share of the population approaching retirement are not saving enough to maintain their preretirement standard of living. It has been found that persons aged 51-61 in 1992 who have household earnings of $30,000 (the median) would need to save 18 percent of their income in the years remaining until retirement, if they wish to retire at age 62 and maintain their preretirement consumption levels throughout retirement. This 18 percent is above and beyond the household's automatic contributions to Social Security and pensions. Postponing retirement to age 65 reduces the necessary saving rate to 7 percent. Typical actual saving rates for persons approaching retirement have been estimated at 2 to 5 percent.

These estimates mask substantial variation within the population approaching retirement. It has been found that roughly 70 percent of households with persons aged 51-61 need to add to their savings, above and beyond their automatic contributions to Social Security and pensions, in order to retire at age 62 and maintain their standard of living; this estimate decreases to 60 percent if retirement is postponed to age 65. But by the same token, roughly one-third do not need to add to their savings to maintain consumption throughout retirement. Not surprisingly, the saving rate necessary to maintain the preretirement standard of living is substantially higher for households with less wealth. Finally, although several theories have been advanced to explain why so many people have a saving shortfall, the available empirical evidence is not conclusive.

To help Americans save enough to enjoy a more secure retirement, the President has proposed to reserve about 12 percent of the projected unified budget surpluses over the next 15 years—averaging about $35 billion a year—to establish new Universal Savings Accounts (USAs). Under the proposed plan, the government would provide a flat tax credit for Americans to put into their USA accounts and additional tax credits to match a portion of each extra dollar that a person voluntarily puts into his or her USA account. This plan would provide more help for low-income workers. These accounts will build on the current private sector pension system to enable working Americans to build wealth to meet their retirement needs.